COMMENTS ON TAX-EXEMPT REFORM PROPOSALS
IN
SENATE FINANCE COMMITTEE STAFF DISCUSSION DRAFT
July 16, 2004

On behalf of the Catholic Health Association of the United States ("CHA"), VHA Inc., and Premier, we thank Chairman Grassley, Ranking Member Baucus, Senate Finance Committee Members, and the committee staff for the opportunity to review the staff discussion draft on exempt organization reforms (the "Discussion Draft"). CHA, VHA, and Premier commend Senators Grassley and Baucus for their attention to – and leadership on – issues pertaining to the financing, operation, and management of tax-exempt entities, foundations, and organizations.

CHA represents more than 2,000 Catholic health care sponsors, systems, facilities, and related organizations, including 617 hospitals. Its members provide a continuum of services in hospitals, long-term care facilities, assisted living, senior housing programs, adult day care, home care, and community-based services. VHA is a nationwide alliance of community-owned, nonprofit health care systems, including more than 2,200 organizations and some of the nation's leading health care institutions. Premier, Inc., a strategic healthcare alliance, is owned by more than 200 of the nation's leading not-for-profit hospital and healthcare systems. These systems operate or are affiliated with 1,500 hospital facilities in 50 states and hundreds of other care sites. Together, these three organizations represent a significant portion of the nonprofit hospitals and health care organizations throughout the United States.

Organizations enjoying tax-exempt status have a duty to ensure that they remain true to their charitable missions. To that end, we appreciate that Senators Grassley and Baucus seek to ensure that tax-exempt organizations operate in a manner that upholds their responsibility to the American taxpayer, meets the expectations of their supporters, and remains true to the organization's mission, goals, and objectives. We understand the need for oversight and accountability for tax-exempt entities and support efforts to identify organizations whose operations and scope do not meet the standards for tax-exempt status. However, there are some issues contained in the Discussion Draft that raise concerns we would like to bring to your attention.

We thank you for your attention to our concerns and stand ready to discuss them further. Please know that we welcome the opportunity to work with you to ensure that any legislation allows exempt organizations to operate efficiently, effectively, and in a manner that best fulfills their public purpose.

Should you have any questions regarding our comments, please feel free to contact T.J. Sullivan at (202) 230-5157 or Kathleen M. Nilles at (202) 230-5140, both partners at the law firm of Gardner Carton & Douglas LLP.

Our specific comments on the proposals contained in the Discussion Draft follow.

A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS

The Discussion Draft contains a proposal that exempt organizations be required to file specified information with the Internal Revenue Service ("IRS") every five years to allow the IRS to determine whether the organization continues to be entitled to exemption. The information would be made publicly available, and the exempt organization may be required to pay a fee to cover the IRS costs of the review.

Comment: We are concerned that the proposed five-year review and mandated submission of documentation would prove burdensome and expensive for all tax-exempt organizations. We are also concerned that the five-year review approach to maintenance of exemption would create uncertainty with respect to the status of tax-exempt bonds utilized by nonprofit organizations to finance facilities. Any resulting disruption of the financial markets and the availability of long-term financing (e.g., 15 to 30 year bonds) would be extremely costly for tax-exempt health care facility issuers and borrowers.

For large public charitable organizations, such as hospitals and health care organizations, we believe the provision of detailed information such as that specified in the proposal is unnecessary. Each year, nonprofit hospitals and health systems submit large amounts of financial data and program information in filing the Return of Organization Exempt From Income Tax (Form 990); thus, underreporting is not an issue in this sector. The IRS lacks sufficient resources to make meaningful use of information it already collects on Form 990 and other information returns. Moreover, the IRS has existing examination authority over tax-exempt organizations and has focused extensively on health care organizations for over a decade. Hospitals and health care organizations are also subject to oversight and review of their activities by varying community or sponsor organizations, state charitable officials, accreditation agencies, and others.

We further are concerned that the penalty contemplated in the Discussion Draft for failure to file a five-year review would be loss of tax-exempt status. The loss of exemption is so serious that it should be reserved to penalize conduct that calls into question the essential nature of the organization as charitable. Financial or other less draconian sanctions should be imposed on organizations that miss a deadline for a required filing or commit other administrative errors.

We recognize that the IRS may need assistance in keeping its files up-to-date with regard to tax-exempt organizations not subject to the annual filing requirement. We do not object to periodic notification requirements for those organizations not required to file IRS Form 990.

2. Donor advised fund reforms

The staff has proposed certain operating restrictions on donor advised funds.

We have no comment at this time.

3. Supporting organizations

The staff has proposed eliminating Type III supporting organizations.

Comment: We are concerned that many reorganized health care system parent organizations may qualify for public charity status only by meeting the Type III "operated in connection with" supporting organization test. We are not certain what abuse the committee staff is attempting to address by this proposal. We suggest that, if this type of proposal is pursued, the committee staff consider creating a new route to public charity status for reorganized health care system parent corporations as was proposed as part of the Health Security Act in 1992.[1/] We also recognize that the health care sector may not be the only sector using a parent-subsidiary model.

4. Revise exemption standards for credit counseling organizations

The committee staff has proposed restrictions on the eligibility for exemption of credit counseling organizations.

We have no comment at the time.

5. Revoke charitable status for accommodations to tax shelters

The committee staff has proposed that charitable organizations determined by the IRS to be accommodating parties to a listed tax shelter transaction or reportable transaction with a significant tax avoidance purpose lose their ability to receive tax deductible contributions for a minimum of one year and pay a 100% tax on the benefits of participating in the transactions.

Comment: We are unclear on some of the specifics of this proposal, including what is meant by "affirmation" that a transaction is not a listed or reportable transaction. We generally are supportive of the staff objective to appropriately penalize organizations and individuals who knowingly participate in a listed tax shelter or reportable transaction with a significant tax avoidance purpose.

[1/] This bill would have preserved the public charity status of organizations that serve as parent holding companies for hospitals by adding to the list of publicly-supported charities: "any organization which is organized and operated for the benefit of, and which directly or indirectly controls: (1) a hospital, the principal purpose or function of which is the provision of medical or hospital care or medical education or medical research . . . ." STAFF OF THE JOINT COMMITTEE ON TAXATION, 103rd Cong., 1st Sess., Description and Analysis of Title VII of H.R. 3600, S. 1757, and S. 1775 ("Health Security Act") at 88-89 (JCS-20-93).

B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules

The committee staff proposes to extend private foundation excise tax rules to public charities, effectively prohibiting any self-dealing transactions between a public charity or social welfare organization and a disqualified person. The staff also proposes broadening the definition of disqualified person.

Comment: We believe this proposed change is unnecessary and oppose it. The Discussion Draft cites early academic proposals to extend the private foundation rules to public charities, including a 1981 law review article by Henry Hansmann. The Congress and the Treasury Department carefully considered these proposals before and during enactment of Section 4958 of the Internal Revenue Code, but ultimately decided to adopt rules similar to, but less restrictive than, the private foundation rules and enact a new system of intermediate sanctions of excise taxes, which was added to the Code as part of the Taxpayer Bill of Rights II in 1996. The private foundation rules are mechanical and unduly restrictive and would make it difficult for hospitals in smaller communities to recruit knowledgeable individuals to their boards. The rules also could make it difficult for nonprofit health care organizations to operate. It is unclear what perceived abuse the staff is attempting to address with this proposal, but we believe Section 4958 is adequate to police self-dealing transactions among public charities, while allowing operational flexibility. If there is a need for further adjustment to those rules, targeted proposals to strengthen Section 4958 would be the preferred approach.

2. Expand definition of disqualified person

The staff proposes to expand the definition of disqualified person to include a corporation or partnership with respect to which a "disqualified person" is a person of substantial influence.

Comment: See comment to #B.1, above.

3. Increase taxes for self-dealing, jeopardizing investments, and taxable expenditures

Comment: See comment to #B.1, above.

4. Compensation of private foundation trustees

The staff proposes to limit compensation payable to nonoperating private foundation trustees.

We have no comment at this time.

5. Compensation of disqualified persons

The committee staff proposes to impose specified limits on compensation of disqualified persons at nonoperating private foundations.

We have no comment at this time.

C. Grants and Expense Reforms

1. Treatment of administrative expenses of nonoperating foundations

The staff proposes to require additional justification for private nonoperating foundations having expenses above specified levels.

We have no comment at this time.

2. Encourage additional grant-making by private foundations

The staff proposes to encourage private foundations to pay out a greater portion of their assets as grants.

We have no comment at this time.

3. Prohibit foundation grants to donor advised funds

The staff proposes to prohibit foundations from making grants to donor advised funds.

We have no comment at this time.

4. Limit amounts paid for travel, meals, and accommodations

The staff proposes to limit payment of expenses for travel, meals, and accommodations to the applicable U.S. government rate or an alternative "nonprofit" rate (to be established).

Comment: We oppose this proposal. We believe that the proposed limitations would hamper many public charities conducting significant interstate or international operations in their ability to fulfill their charitable missions. As private organizations, charities are not entitled to obtain government rates from common carriers, hotels, or other service providers. Moreover, because such organizations lack the buying power of the U.S. and state governments, it will be difficult for them to find airlines and hotels willing to extend the government-level rate. Thus, limiting

expenses to government levels is not feasible. Further, establishing an alternate nonprofit rate system would be unworkable.

As a result of the proposed limitations on payment for organizational travel, many nonprofit executives and rank-and-file employees would inevitably incur significant nondeductible and unreimbursable out-of-pocket expenses. Allowing an exception from the limits only where there is board-level approval of each expense and disclosure of the payments on the organization's Form 990 would be burdensome and distract boards of directors from their important responsibilities of overseeing management of charitable organizations and assisting in strategic planning. This proposal would hamper an exempt organization's ability to recruit and retain an experienced workforce.

D. Federal-State Coordination of Actions and Proceedings

1. Establish standards for acquisition/conversion of a non-profit

The staff proposes to create standards for review by state and federal authorities of conversion transactions in order to ensure that an acquisition or conversion occurs only if it is found by the state or federal reviewer to be necessary to serve the public interest and best serves the interest of the intended beneficiaries of the organization's assets. The Discussion Draft would implement an IRS reporting requirement within ten days of establishing an "intent to pursue a conversion transaction." It would also allow the IRS up to one year to approve or disapprove a transaction and to penalize unapproved transactions by imposing tax at the highest corporate rate on built-in gains. In addition, the proposal would impose modified self-dealing transaction rules with respect to any severance arrangements and other officer or employee compensation arrangements (including stock awards) entered into in connection with a conversion transaction.

Comment: We commend the committee staff for including proposals to address the serious issues that have arisen in connection with the occurrence of nonprofit to for-profit conversions. We share what we perceive to be the two overriding goals of the proposals—preserving charitable assets for charitable purposes and preventing the inappropriate diversion of charitable assets to private individuals.

Traditionally, state governments (generally through the work of their attorneys general) have exercised authority over charitable trust issues. While we agree that there may be a need for more uniformity among the states, we are wary of vesting significant additional authority in the IRS. The IRS may not have the resources to devote to such advance transaction approval. Striking the proper balance between federal and state jurisdiction will require careful consideration of the long-run consequences. We look forward to working with committee staff to achieve an appropriate balance.

With respect to severance and compensation arrangements for executives of converting nonprofits, we support the trend toward public disclosure surrounding such arrangements. We

also support careful consideration of whether the intermediate sanctions of Section 4958 reach and adequately address these arrangements. If changes are needed to curb abusive arrangements and side deals, we would be happy to work with the committee staff to address these issues.

2. Provide states the authority to pursue federal actions

The staff has proposed that states be given authority to pursue certain federal tax law violations with the approval of the IRS.

Comment: We welcome even-handed enforcement, but are concerned that the staff proposal may lead to inconsistency and uneven enforcement of federal tax law. The IRS knows federal tax law best and should be given adequate authority and resources to enforce the law. If the IRS reaches a decision not to take a particular action or pursue a particular potential violation, that decision should be respected and final. Accordingly, we oppose this proposal.

E. Improve Quality and Scope of Forms 990 and Financial Statements

The staff has proposed improvements to the IRS Form 990 (*Return of Organization Exempt From Income Tax*) as follows.

1. Require signature by chief executive officer

The staff proposes requiring a tax-exempt organization's Chief Executive Officer ("CEO") to declare under penalties of perjury that he or she has put into place processes and procedures to ensure that the return complies with federal tax law and that the CEO has been provided reasonable assurance of the accuracy and completeness of the return.

Comment: We do not object to CEO certification with respect to a return if, like the approach taken in the Sarbanes-Oxley Act, it is limited to the CEO's reasonable knowledge and the certification standards are narrowly drafted and clear. We look forward to working with other stakeholders and the committee staff to help craft appropriate language that meets these criteria.

2. Penalties for failure to file complete and accurate 990

The staff proposes to increase penalties for failure to file a complete and accurate annual information return.

Comment: We do not object to reasonable financial penalties. However, we oppose revocation of exemption as a penalty and believe the IRS should retain discretion over the imposition of failure to file penalties. In particular, it should have discretion to abate substantial financial penalties where failure to file is due to reasonable cause.

3. Penalty for failure to file timely 990

The staff proposes to limit the use of extensions.

Comment: In balancing the public's need for information against exempt organizations' information return filing obligations, we believe the IRS has adequate authority under common law to determine whether and when extensions of filing dates are appropriate. We do not support this proposal.

4. Electronic filing

The staff proposes to allow the IRS to require exempt organizations to file returns electronically.

Comment: We support this proposal.

5. Standards for filing

The staff proposes to require the IRS to promulgate standards for filing a Form 990, which appears to be aimed at standardizing reporting among taxpayers.

Comment: Although we support efforts to make the data reported on Form 990 more useful for regulators and the public, we would urge the IRS to work with the American Institute of Certified Public Accountants and the Financial Accounting Standards Board in developing standardized reporting requirements. We welcome the opportunity to work with the committee staff and other interested stakeholders to identify reasonable means to achieve the committee's desired goal.

6. Independent audits or reviews

The staff proposes to subject IRS Form 990 to a review by an independent auditor and to require an independent audit of an organization's financial statements, including certification regarding exposure to the unrelated business income tax for organizations with over $250,000 of gross receipts. The exempt organization would be required to attach the auditor's report to its

Form 990 and make such report available to the public. The proposal also includes a requirement that a new auditor must be used at least every five years.

Comment: We support the objective underlying the Discussion Draft of attempting to improve the content and reliability of Form 990 and the independence of auditors. As drafted, however, we are concerned that the proposal may prove extremely costly for charitable organizations and creates an unprecedented distinction between the tax reporting obligations of nonprofit and for-profit organizations. The function of the IRS is to audit and examine tax returns, including Forms 990. The effect of this proposal would be to require private accounting firms to perform the IRS's audit and examination functions at great expense to exempt organizations. For-profit organizations are not required to have their tax returns audited by private accounting firms.

Audits of charitable organization financial statements are already extremely expensive, especially for small organizations. The certification requirement would further increase this already extremely expensive process and again substitute a private accounting firm's judgment for that of the taxpayer and the IRS. Accordingly, we strongly oppose the proposal.

7. Enhanced disclosure of related organizations and insider transactions

The staff has proposed requiring tax-exempt organizations to attach to the Form 990 an affiliation chart showing the organization's relationship with respect to all of its exempt and taxable affiliates. The proposal also would require additional reporting about taxable subsidiaries and transactions with them, as well as about insider transactions and ancillary joint ventures. The staff proposes requiring exempt organizations to attach to Form 990 a schedule listing partnership interests and the organization's role in the partnership. In addition, organizations would be required to attach to the Form 990 all tax opinions received by the organization involving agreements with insiders and all conflicts of interest opinions.

Comment: We generally support the idea of transparency with respect to corporate relationships and affiliations among corporations both exempt and nonexempt. However, we strongly object to the proposal to require an exempt organization to attach to its Form 990 any tax opinions received by the organization involving agreements with insiders and all conflicts of interest opinions. For-profit organizations, even in the era of corporate responsibility, are not required to disclose tax opinions. Any requirement to make public tax opinions would destroy the attorney-client privilege and serve as a strong disincentive for organizations to seek professional opinions or the advice of counsel.

8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements

The Discussion Draft proposes to require charitable organizations with over $250,000 in gross receipts to include in Form 990 a detailed description of the organization's annual performance goals and measurements for meeting those goals. Further, charitable organizations would be required to disclose material changes in activities, operations, or structure. All exempt

organizations would be required to report how often the Board of Directors met, and how often it met in Executive Session.

Comment: We are concerned that requiring a detailed description of annual performance goals and measurements for meeting those goals would be extremely burdensome for complex health care and educational organizations. This essentially would require publication of an organization's strategic goals, including service and market share obligations, which could have an anti-competitive effect. The IRS already requires material changes in operations or structure to be reported. We do not object to the proposal to require disclosure of the frequency of board meetings and executive sessions. We note that the stated desire to assist donors to better determine whether to donate is not applicable to all Section 501(c)(3) organizations as some do not rely in any material way on charitable contributions.

9. Disclose investments of public charities

The staff has proposed that public charities be required to make public upon request a description of their investments.

Comment: While we generally support this kind of transparency, we have concerns about the potential burden. Thus, we would welcome the opportunity to work with the staff to ensure that this proposal is drafted in a manner that is not unnecessarily burdensome.

F. Public Availability of Documents

1. Disclosure of financial statements

The staff has proposed that exempt organizations be required to disclose their financial statements to the public.

We have no comment at this time.

2. Web-site disclosure

The staff has proposed that every exempt organization be required to post on its web-site (i) all returns subject to public disclosure, (ii) its application for exemption and determination letter, and (iii) financial statements for the five most recent years.

Comment: Existing law requires exempt organizations to make available upon request the last three years of IRS Forms 990 as well as their application for exemption. We believe this is sufficient for public dissemination of this information and note that web-sites, such as Guidestar and similar dissemination vehicles, already exist. Moreover, we are concerned that this

proposal would be overbroad and unduly expensive in requiring a significant volume of information to be placed on an organization's web-site.

3. Publication of final determinations

The staff has proposed that the results of IRS examinations of tax-exempt organizations and IRS closing agreements with exempt organizations be disclosed without redaction. This proposal is modeled after a recommendation of the Staff of Joint Committee on Taxation in January 2000.

Comment: We oppose this recommendation for the reasons discussed below and note that this information is not subject to disclosure with respect to taxable organizations. We believe existing law regarding confidentiality of these materials should be preserved. We do not believe that disclosure of audit results and closing agreements would add in a meaningful way to the information otherwise available to the public regarding a tax-exempt organization's compliance with the law and its use of funds. In the absence of such a benefit, we believe that the negative effects of such disclosure far outweigh any meaningful increase in the public's ability to oversee tax-exempt organizations.

Only a limited number of tax-exempt organizations are examined in any year. A disproportionate number are large organizations, such as universities and health systems. The unredacted disclosure of examination results would create two classes of exempt organizations -- those that have been examined and those that have not. Whether an organization has been examined typically is no indication of its compliance with the law. Thus, a meaningless and potentially misleading classification would be established that adds little or nothing to the public's oversight ability.

We are very concerned that release of this information with respect to a small number of tax-exempt organizations each year invites misinterpretation and misuse of the information. Audit findings that may be minor or insignificant from the IRS's perspective, but could be damaging to an exempt organization's reputation nevertheless, will make their way to the front pages of newspapers, and could escalate into significant public relations problems. Worse, this information is ripe for misuse by litigants (including proponents of class-action suits), philosophical opponents, and competitors. Releasing IRS audit information and closing agreements involving tax-exempt organizations, while holding confidential the same information involving taxable organizations, places exempt organizations at a disadvantage and could weaken charitable health care providers, invite further conversions to for-profit status, and erode public confidence in the remaining nonprofits. Further, many of the issues addressed in an IRS examination are not unique to tax-exempt organizations and do not even relate to tax-exempt status. For example, there appears to be no compelling public interest in publicizing whether a particular tax-exempt organization has properly characterized certain individuals as employees or independent contractors, a common issue for colleges, universities, and hospitals. Certainly such information would not be subject to disclosure for any other taxpayers, including taxable schools or hospitals.

Most importantly, disclosure of audit results and closing agreements likely would have a harmful effect on tax administration and voluntary compliance. It likely would result in a lengthening of the audit process and post-audit litigation because tax-exempt organizations would have a disincentive to compromise with the IRS on disputed matters. An organization may reasonably be concerned that such a compromise could be misconstrued as an admission of failure to comply with the law. Similarly, a tax-exempt organization would be less likely to come forward, independent of the audit process, to resolve with the IRS potential tax issues it may discover on its own.

Under current law, a tax-exempt organization may choose to compromise a contested position during an examination or as part of a closing agreement without any implication that its original position was not in compliance with the law. Many, if not most, disputed issues compromised during the course of an examination relate to areas in which the law is not clear. In the case of a closing agreement initiated by the taxpayer, the organization has identified an area of possible noncompliance and seeks the assistance of the IRS in resolving the matter, including through implementation of agreed-upon corrections. Where the tax-exempt organization has made a good-faith attempt at compliance or correction, the public interest is best served by a compromise acceptable to both the taxpayer and the IRS. The legislative history of the intermediate sanctions excise tax states that revocation of an organization's tax-exempt status should be reserved for situations in which the organization no longer operates as a charitable organization. The decision to resolve any disputed issues without revoking exempt status indicates that the IRS has determined that the organization continues to operate as a charitable organization or that the dispute did not involve issues relating to the organization's tax-exempt status. Thus, it is difficult to see how disclosure of examination results or closing agreements adds in any meaningful way to the public's interest in compliance by tax-exempt organizations.[2/]

4. Require public disclosure of Form 990-T and affiliated organization returns

The staff proposes to require Form 990-T, the tax return filed by exempt organizations with unrelated business income tax, to be made public and further proposes that the tax returns filed by affiliated organizations be made public. This follows a recommendation of the Staff of the Joint Committee on Taxation in January 2000.

Comment: We oppose these recommendations. Tax-exempt organizations are expressly permitted to engage in nonexempt activities, through conduct of an unrelated trade or business or through a separate organization such as a partnership or taxable corporation. Such activities are treated in the same manner as the activities of other taxable entities and are subject to the same tax liabilities. Taxation of these activities in the same manner as the activities of any other taxable entity preserves a level playing field and prevents unfair competition. To subject the tax

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[2/] The above comments and comments in Section F.4 are similar to comments made by the nonprofit hospital sector shortly after release of the Joint Committee study referred to in the Discussion Draft. *See* Comments of The Coalition for Nonprofit Health Care on the Joint Committee on Taxation Staff Disclosure Study submitted to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, March 15, 2000; Statement of VHA Inc. submitted for the Record to the Committee on Ways and Means on the Joint Committee on Taxation Disclosure Study (March 13, 2000).

returns for these taxable businesses to disclosure, when other taxable businesses are not subject to disclosure, creates a non-level playing field and would place nonprofits' subsidiaries and other affiliates at a competitive disadvantage. Disclosure of the detailed information in these returns may also make it more difficult for affected organizations to attract skilled managers and may inhibit relationships with potential investors or business partners, who may be reluctant to enter into transactions if the details will be made public. There is no meaningful public benefit from such disparate treatment and any bases for public interest in an organization's exempt activities do not apply to taxable activities.

The nonprofit health care sector, in particular, would be unduly burdened and harmed by required disclosure of taxable affiliates' returns. Health care organizations have developed complex multi-corporate structures as a legitimate means to address liability concerns and the unique regulatory environment in which they operate. Moreover, investor-owned and specialty companies are aggressively moving into some of the more profitable venues in health care, and could use increased disclosure by taxable affiliates of nonprofits as a road map to cherry-pick financially attractive activities, leaving a diminished nonprofit sector to conduct money-losing activities that benefit communities. It is difficult to identify a public interest that would justify this kind of potential harm.

5. Require public corporation filing of charitable giving return

The staff has proposed that publicly-traded corporations be required to annually file a publicly-available return that would show all charitable contribution deductions over $10,000 (in the aggregate) during a taxable year.

Comment: We support this proposal.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Board duties

The Discussion Draft suggests that federal liability be imposed to reinforce the traditional state-law fiduciary duties of directors and trustees of charitable organizations. It also proposes specific board duties, including board retention of independent compensation consultants, advance board approval of compensation increases for all management-level officers and employees, board retention and rotation of independent auditors, board approval of significant investments and business ventures, board adoption of a conflicts of interest policy, execution of conflicts procedures, board establishment and oversight of a compliance program, and board adoption of a plan to protect whistleblowers. The Discussion Draft would require organizations to report on their boards' compliance with these new federal requirements on the IRS Form 990.

Comment: Nonprofit tax-exempt organizations have long been subject to well-developed bodies of law at the state level. These bodies of nonprofit corporation law have developed over decades and, while there has been some movement toward uniformity, they continue to vary reflecting

values and politics in the fifty states. We believe that the imposition of an overarching federal law, even if modeled after the most common elements of state law, would be unwise at this point and would serve as one more impediment to Board service in an era where perceived responsibilities of Board members is growing and changing dramatically. Most importantly, all of us in the tax-exempt sector are witnessing -- and part of -- a dramatic movement toward defining and adopting best practices in the governance area stimulated by reactions to public company accounting and governance lapses and the enactment of the Sarbanes-Oxley Act. Though we share the committee's desire to appropriately encourage all tax-exempt organizations, large and small, to adopt best practices appropriate for their size and mission, we believe it unnecessary and unwise to attempt at this point to legislate a federal set of standards.

The Discussion Draft includes certain specific requirements with respect to compensation for management-level employees and a requirement of plain language disclosure. Charitable organizations are already subject to the requirements of the Internal Revenue Code. Section 4958 and the regulations thereunder provide specific guidelines for determining compensation using an independent approval body and appropriate comparability data. We believe the Discussion Draft's proposals in this area are therefore ill advised.

We do support the proposal that an independent auditor be hired by large tax-exempt organizations and appropriate rotation of audit partners in much the same manner as applicable to public companies under Sarbanes-Oxley. However, we do not believe it appropriate to impose the detailed requirements on a board to approve the auditing and accounting principles and practices used in preparing the organization's financial statements. Achieving that goal is exactly why an organization hires an outside independent auditor. Again, recognizing that governance best practices are fast being embraced by larger tax-exempt organizations, we are supportive of appropriate encouragement of that trend. Accordingly, we would support a requirement that Form 990 ask whether the governing board has hired an independent auditor to audit the financial statements and whether the audit partner has been subjected to rotation within a five-year period. Because we object to the other more proscriptive staff proposals, we also object to a confirmation requirement for those proposals. However, we would support amendments to the Form 990 that ask appropriate governance questions with respect to the adoption of certain agreed best practices as those practices develop over time.

2. Board composition

The Discussion Draft suggests requiring that boards be composed of no less than three and no more than 15 members. No matter how many members a board might have, not more than one member could be a person compensated directly or indirectly by the organization. In addition, at least one member or one-fifth of the directors of any public charity board would be required to be "independent" (defined as "free of any relationship with the corporation or its management that may impair or appear to impair the director's ability to make independent judgments"). Finally, the Discussion Draft would not allow any person who is compensated by the organization to serve as the Board's Chairman or Treasurer.

Comment: We believe that the Discussion Draft is far too proscriptive and would substitute a heavy-handed set of federal requirements for decisions that have long been left to the discretion of tax-exempt boards under applicable state laws. While having a minimum of three directors is

common under state nonprofit corporation laws, capping the number of board members represents a dramatic departure from current law and would work a hardship on any charitable organization boards that have individuals representing other organizations, individuals with proven fundraising experience, and boards that have chosen for other reasons to be larger than the Discussion Draft would permit. Limiting the number of management or inside directors to one also seems unduly restrictive as do the new narrower definition of "independent" in the Discussion Draft and limits on the ability of the CEO or another management director to serve as Chairman or Treasurer. To the extent that the committee seeks to ensure that sufficient numbers of board members are independent or that they possess appropriate expertise to ensure their ability to review management and financial performance of the organization, we believe the committee would be better served by taking an approach similar to that under the Sarbanes-Oxley Act requiring disclosure as to whether the Board has an independent audit committee and has members of that committee with sufficient financial background.

3. Board/officer removal

In addition to prohibiting exempt organization board service by any individual who is not permitted to serve on the board of a publicly traded company, the Discussion Draft would give IRS the authority to require the removal of any board member, officer, or employee of an exempt organization who has been found to have violated various laws and rules (*e.g.*, private inurement, self-dealing, excess benefit, charitable solicitation, and other rules applicable to exempt organizations).

Comment: Giving IRS the authority to require the removal of a board member found in a valid judicial proceeding to have violated a criminal law would not be objectionable. However, we would object to any attempt to impose such penalties for violations of civil law not determined by a valid judicial authority or to federalize the enforcement of state laws, such as the charitable solicitation laws of the various states.

4. Government encouragement of best practices

The Discussion Draft recommends that good governance practices be encouraged by (a) giving preferred status in federal grantmaking determinations to nonprofit organizations that are accredited as having adopted best governance practices. (Such accreditation would be conducted by IRS-designated accreditation entities.) In addition, the IRS, together with the Office of Personnel Management, would establish best governance practices for organizations wishing to participate in the Combined Federal Campaign (the annual fundraising drive in which charitable organizations have the ability to receive donations from individual federal employees).

Comment: We support proposals to appropriately encourage the development of best practices among tax-exempt organizations of all sizes. As discussed above, a movement toward best practices is rapidly spreading throughout the exempt organization community. In this regard, education and disclosure requirements can be useful mechanisms to encourage best practices while permitting pluralism during their development without an unnecessarily heavy-handed approach. However, we believe that creating a new bureaucracy of accreditation is not the best approach in this regard.

5. Accreditation

The Discussion Draft recommends that Congress authorize a grant of $10 million to the IRS to support accreditation of charities nationwide. It is not clear whether the staff intends an annual or one-time grant. The IRS funds would be made available to nonprofit organization accreditation entities, including membership organizations with an accreditation function for specific classes of nonprofits (*e.g.*, nonprofit hospitals, zoos, and universities).

Comment: The policy considerations surrounding this proposal are not clear at this time. Therefore, we have no comment.

6. Establish prudent investor rules

The Discussion Draft recommends that Congress consider the adoption of a federal prudent investor rule based on existing state standards applicable to nonprofit organizations.
Comment: There is already a movement among states to adopt the model Uniform Prudent Investor Act. We do not believe it is appropriate to impose a federal uniform standard on the states.

H. Funding of Exempt Organizations and State Enforcement and Education

The staff has proposed to reinstate the authorization for appropriating up to $200 million of revenue from the tax on the net investment income of private foundations to Exempt Organizations and has proposed a filing fee on exempt organization returns.

We have no comment on the appropriation issue at this time. However, we oppose imposition of a Form 990 filing fee.

I. Tax Court Equity Authorities, Private Relator and Valuation

1. Tax Court Equity Authorities

The staff has proposed to invest the U.S. Tax Court with equitable powers and remedies (including the power to rescind transactions, order accountings, and remove directors and officers in appropriate circumstances) with respect to philanthropic organizations. In situations where state authorities initiate action, the staff has proposed that state courts not be permitted to defer or abate the imposition of the initial federal excise taxes for violations of substantive rules.

Comment: We have no comment at this time other than to note that this and any similar proposals should be carefully evaluated in an appropriate public forum as they raise important issues of federal-state relations.

2. Private Action – Directors

The staff has proposed to allow any director or trustee to bring a proceeding on behalf of an exempt organization.

Comment: See #I.1, above.

3. Private Relator Action – Individual

The staff has proposed to allow any individual to file a complaint with the IRS regarding a charity.

Comment: See #I.1, above.

4. Valuation Resolution

The staff proposes a mandatory "baseball arbitration procedure" to resolve valuation disputes between a taxpayer and the IRS. The taxpayer and the IRS each become bound by their respective valuations at different points in the process; however, during the examination stage of the proceeding, the IRS is free to negotiate with the taxpayer to reach an agreement up to the issuance of the notice of proposed audit adjustment.

We have no comment at this time.

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